

THE FUNDAMENTALS OF DEBT FINANCING

INITIAL AND CONTINUING DISCLOSURE

Presented by:

Lisa Greer Quateman, Esq., Quateman & Zidell LLP

Marshall Eyerman, MuniFinancial



Terminology

- Initial Disclosure Document
- Continuing Disclosure
- Retail and Institutional Investors
- Dissemination Agent
- Disclosure Consultant
- NRMSIR / SID
- CUSIPs



RULES AND REGULATIONS

Securities and Exchange Commission

- Federal securities laws govern municipal securities offerings
- Municipal Bonds are generally exempt from registration under Securities Act of 1933
- “Anti-fraud” provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 apply

Securities and Exchange Commission

- The SEC is statutorily barred from regulating the municipal securities markets but does regulate broker-dealers, *i.e.*, underwriters
- The SEC communicates its views on disclosure matters to the bond community through various releases and enforcement proceedings

Securities Act of 1933

- Section 17 (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mail, directly or indirectly:

Securities Act of 1933 - Cont.

- (1) to employ any device, scheme or artifice to defraud, or
- (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

Securities Act of 1933 - Cont.

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser

Securities and Exchange Act of 1934

- Section 10 - It is unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange

Securities and Exchange Act of 1934 - Cont.

(b) to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the commission may prescribe as necessary or appropriate in the public interest or for the protection of investors

SEC Rule 10b-5

- It is unlawful :
 - to employ any device, scheme, or artifice to defraud,
 - to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

SEC Rule 10b-5 - Cont.

- to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security

SEC Rule 10b-5 - Cont.

- Whatever you do or say, be accurate
- Do not leave any material information out if it would change the nature of what has been said
- Do not just blame the professionals, issuers have primary liability
- *Applies to both Initial and Continuing Disclosure!*

Supreme Court

- A statement or omission is material if there is a *substantial* likelihood that a *reasonable* (not “any”) investor *would* (not “could”) consider it *important* (not “interesting”) in making the *decision* to purchase or sell the securities.



Elements of Materiality

- Unusual, Alarming, Worrisome
- Red Flags
- Probability Versus Magnitude
- Private Securities Litigation Reform Act of 1995
 - Limited safe harbor for “forward-looking statements”

Legal Basis for Liability

- Fraud or deceit ("scienter")
 - Intentional wrongdoing
 - Recklessness ("...an *extreme* departure from the standards of *reasonable* care")
 - Knowledge can be what you *should* have known (*i.e.* you can not be intentionally ignorant)

Legal Basis for Liability

- Negligence
 - Standard for SEC enforcement action under Section 17(a)(2) or (a)(3) of the Securities Act of 1933
 - Failure to act in accordance with standards of reasonable care
 - Lower threshold than “intentional wrongdoing” or “recklessness”

Elements of Recklessness

- Method of preparation
- Refusal to see the obvious or to investigate the doubtful
- It's in the process

SEC Rule 15c2-12

- Disseminate Reports
 - Nationally Recognized Municipal Securities Information Repository (NRMSIR)
 - Bloomberg Municipal Repository
 - DPC Data Inc.
 - Standard & Poor's JJ Kenny
 - FT Interactive Data
 - State Information Depositories (SID)
 - Texas, Michigan and Ohio
 - Municipal Securities Rulemaking Board (MSRB)



Overview of SEC Rule 15c2-12

- **Purpose:**
 - To ensure that brokers and dealers review secondary market disclosure practices of issuers and other “Obligated Persons” at the time of an offering of municipal securities
 - To enable investors to protect themselves from misrepresentation and fraudulent activities

Application of 15c2-12

- Prohibits underwriters from underwriting *unless* an exemption applies or the Issuer or an Obligated Person agrees to provide certain ongoing information

Exemptions from Section (b)5 of Rule 15c2-12

- Section (b) 5 does not apply to securities in authorized denominations of \$100,000 or more if the securities:
 - Are sold to no more than 35 persons whom underwriter reasonably believes:
 - Has financial expertise to evaluate the merits and risks of the investments
 - Is not purchasing for more than one account or to distribute ("Experienced Investor Exemption")
 - Have a maturity of 9 months or less
 - May, at the option of the Holder be tendered to Issuer at at least par value or more at least every 9 months

Exemptions from Section (b)5 of Rule 15c2-12

- Paragraph (b)(5) does not apply if at the delivery of the securities:
 - No Obligated Person is an Obligated Person with respect to more than \$10M in aggregate amount of outstanding municipal securities (including the offered securities)
 - The Issuer has undertaken for the benefit of the Holders of the securities
 - To file at least annually with NRMSIR and SID Annual Financial Information including operating data as found in the Official Statement

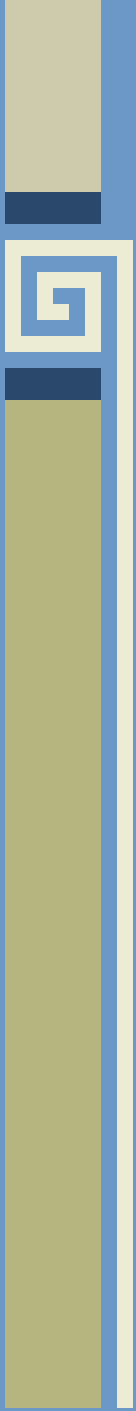
Exemptions from Section (b)5 of Rule 15c2-12

- The Issuer has undertaken for the benefit of the Holders of the securities
 - To file with NRMSIR and SID Annual Financial Information including operating data as found in the Official Statement
 - To file with the NRMSIR, SID and MSRB any Material Event Notice
- The Official Statement identifies by name, address and telephone number the persons from whom the information can be obtained
- Other than with respect to Material Event Notices, where the securities have a stated maturity of 18 months or less

Exemptions from Rule 15c2-12

Material Events Disclosure

- Sold in an offering where Paragraph (b)(5) does not apply, except where a continuing disclosure undertaking has been signed
- Sold in an offering that was exempt pursuant to Paragraph (d)(1):
 - Experienced Investor Exemption
 - Maturity of 9 months or less
 - May be tendered at least every 9 months

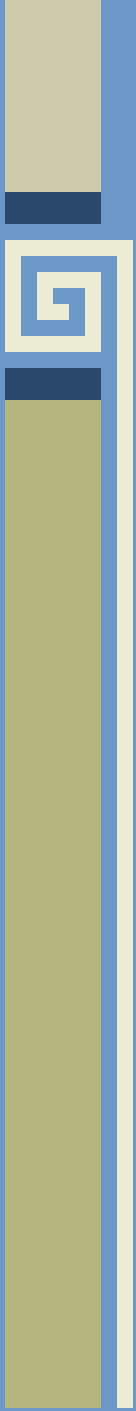


DISCLOSURE DOCUMENTS



The Disclosure Documents

- Official Statement
- Continuing Disclosure Undertaking
- CDIAC Notices



DISCLOSURE DOCUMENTS Before the Sale

Official Statement Structure and Content

- Introduction
- Description of the Bonds
- Security
- Redemption
- Debt Service Schedule
- Sources and Uses of Funds
- Description of Issuer
- Risk Factors
- Concluding Sections
- Appendices re:
Financials and
Demographics



General and Demographic Data

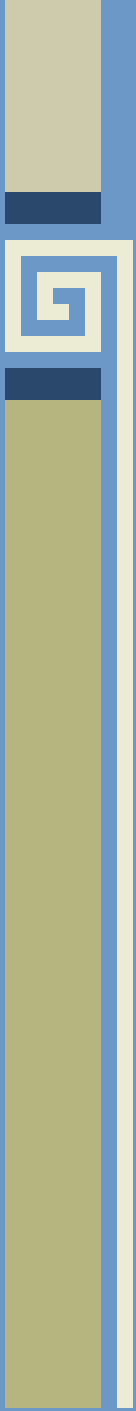
- Description of Issuer
- Form of Governance
- Population
- Labor Relations
- Industry and Employment
- Commercial Activity
- Construction Activity
- Principal Taxpayers
- Investment Policy
- Direct and Overlapping Debt

Preliminary Official Statement

- The POS is circulated to prospective purchasers
- It contains substantively the same information concerning the financing and the credit as the Official Statement
- Since it is circulated prior to the sale, the exact principal amount of bonds, interest rate, optional redemption premiums and the like are generally omitted

CDIAC NOTICES

- **Report of Proposed Debt Issuance**
 - Provides CDIAC general information regarding the issuance
 - Required to be filed 30 days prior to the proposed sale of any public agency debt issuance



DISCLOSURE DOCUMENTS After the Sale

CDIAC NOTICES - Cont.

- **Acknowledgement of Report of Proposed Debt Issuance**
 - CDIAC will send an acknowledgement upon receipt of the Report of Proposed Debt Issuance
- **Report of Final Sale**
 - Issuers are required to provide this report to CDIAC within 45 days of the signing of a purchase agreement or accepting a bid

Continuing Disclosure Undertaking

- The Continuing Disclosure Undertaking is entered into by:
 - the Issuer and/or the Obligated Persons
 - The undertaking is sometimes an agreement between the Obligated Person and the Indenture Trustee or other Designated Dissemination Agent
- For the benefit of the holders of the municipal securities



Financial and Operating Data

- **Provided for:**
 - Each Obligated Person for whom financial information or operating data is presented in the Final Official Statement
- **Annual financial information must be submitted to each:**
 - Nationally Recognized Municipal Securities Information Repositories - NRMSIRs
 - State Information Depository - SID

Obligated Persons

- Issuer
- Any person committed by contract or other arrangement to support any payment of the Bonds
- Obligated Persons *does not* include providers of:
 - Municipal Bond Insurance
 - Letters of Credit
 - Other Liquidity Facilities

Good Disclosure — It's In the Process

- Gather the Information
- Filter the Information
- Prepare the Information for Distribution
- Coordinate Approval
- Remember – The Content is the Issuer's Responsibility

Report Dissemination

- Cover Sheet and CUSIPs
- NRMSIRs/SID
- Internet
- Directly to Investors



MATERIAL EVENT NOTICES



Material Event Notices

1. Principal and Interest Payment Delinquencies
2. Non-payment Related Defaults
3. Unscheduled Draws on Debt Service Reserves Reflecting Financial Difficulties
4. Unscheduled Draws on Liquidity Enhancement Reflecting Financial Difficulties
5. Substitution of Credit or Liquidity Providers or Failure of Credit or Liquidity Providers to Perform

Material Event Notices - Cont.

6. Adverse Tax Opinions
or Events Affecting Tax
Exempt Status of Bonds

7. Modification to Security
Holder's Rights

8. Bond Calls

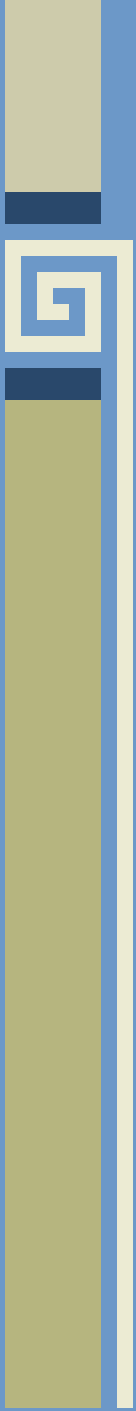
9. Defeasances

10. Release,
Substitution or Sale of
Property Securing Bond
Repayment

11. Rating Changes



CURRENT TOPICS



ELECTRONIC DISSEMINATION OF INFORMATION

Websites and Securities Law

- Rule 10b-5
 - Municipal issuers must ensure that their electronic disclosure complies with Rule 10b-5

Websites and 15c2-12

- The 1994 Release
 - When an Issuer releases information to the public
 - Reasonably expected to reach investors
 - That information is subject to the SEC's antifraud rules

Websites and 15c2-12 - Cont.

- 1994 Release Cont.
 - Even if the information is not published for purposes of informing investors, antifraud rules still apply
 - Statements by Issuers are a principal source of significant, current information about the Issuer and can reasonably be expected to reach investors and the trading market

Websites and 15c2-12 - Cont.

- The SEC 2000 Release
 - Federal securities laws apply in the same manner to the content of an Issuer's website as to any other statements made by or attributable to the Issuer
 - Issuers are responsible for the accuracy of their statements that can reasonably be expected to reach investors in the securities markets regardless of the medium
 - Electronic offering document practices

Segregation of Investor Information

- Information on an Issuer's website can reasonably be expected to reach investors
 - Issuers should consider unauthorized republication issues relating to posting information on their websites
- This is true regardless of whether the information posted on the website is intended to reach investors

Segregation of Investor Information - Cont.

- Issuer can be held liable under 10b-5 for third-party information to which the issuer has hyperlinked from the Issuer's web site if:
 - The Issuer has involved itself in the preparation of the information
 - Explicitly or implicitly endorsed or approved the information

Segregation of Investor Information - Cont.

- **The Envelope Theory**
 - Documents delivered with (in the same envelope as) disclosure information are considered to be part of the disclosure
- On a website, all information could be considered “in the same envelope”
- Thus an Issuer could be held liable for the accuracy and completeness of all information on its website

Disclaimer for Disclosure Information

- A disclaimer helps the Issuer comply with Federal securities laws by:
 - Permitting the Issuer to provide information to the investor
 - Expressly seeking to limit the scope of the Issuer's responsibilities for the accuracy and completeness of the information

Disclaimers - Continued

- **Example**
 - Certain information speaks only as of its date
 - Information will not be updated
 - Offering documents do not constitute an offer to sell or a solicitation of an offer to buy securities
 - Information posted is subject to change
- Information is for general informational purposes only
- Information is not “full and fair disclosure”
- Estimates or projections are contained in the information
- Actual results may differ materially
- and so on

Internal Control of Disclosure Documents

- Again, the Issuer must ensure that all disclosure is accurate and complete
- Accuracy implies that contradictory information will not be disclosed simultaneously
- To assure accuracy, it is necessary for the Issuer to monitor all disclosure



Internal Control Suggestions

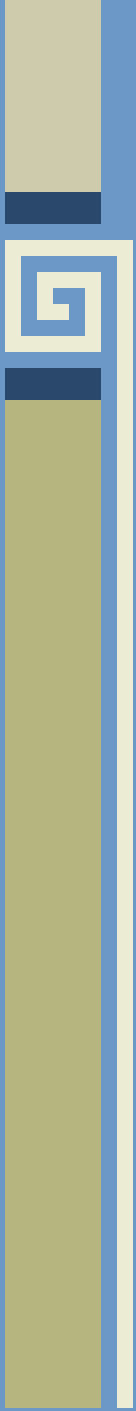
- **Issuer should:**
 - Assign one department or individual the responsibility of assuring the accuracy of all disclosure
 - Consider the type of information made available to investors on its website
 - Evaluate how to best monitor all website information

Internal Control Suggestions - Cont.

- Issuer should:
 - Track and maintain evidence of all disclosure filings
 - Liaise with Bond Counsel regarding interpretation of indenture provisions regarding financial calculations

Internal Control Suggestions - Cont.

- **Issuer should:**
 - Review disclosure information on the Website on a regular basis
 - Particularly when the Issuer is preparing to issue debt
 - Evaluate information at least quarterly
 - More frequently if material financial or operating information becomes available or
 - When current issues affecting investors' perception of the issuer's credit arise



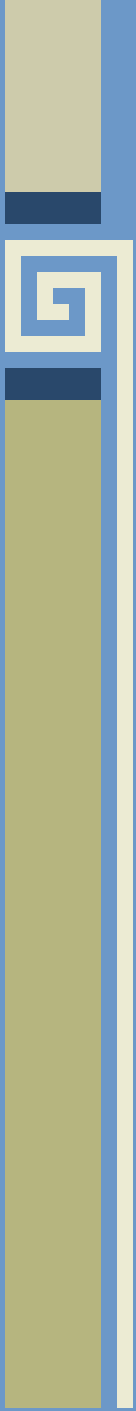
Unfunded Actuarial Accrued Liabilities (UAAL)

UAAL

- UAAL = Retirement system actuarial value of assets less actuarial accrued liabilities
- Concerns about the health and funding of pension funds have been increasing
- Public pension funds are not governed by ERISA
 - Therefore are not guaranteed by the Pension Benefit Guaranty Corp.

UAAL - Cont.

- Due to market slowdowns additional funding by plan sponsors is required to maintain proper pension fund funding
- Rating agencies treat unfunded pension obligations similar to bonded debt
- Issuers should carefully review their UAAL for disclosure issues



Internal Revenue Service Circular 230

Circular 230

- The US Treasury removed an exemption for tax-exempt bond opinions from a proposed tax-shelter rule
- If the rule change is instituted, Bond Counsel would be required to include in writing all material tax issues in any bond opinion

Circular 230

- Issuers should consider disclosure issues with respect to the proposed rule change
 - The extent and substance of such disclosure may be affected by the timing of proposed rule change including issues regarding:
 - POS printing prior to rule change
 - OS printing after rule change

Hot Topics

- “Recommended Best Practices”
(*www.nfma.org*)
- Internet Publishing and Access
- Timing and Frequency of Disclosure Reports
- MuniCouncil
- Central Post Office
- Proposed ERAF shift

Industry Publications and Sources of Guidance

- Disclosure Guidelines for State and Local Government Securities
- National Federation of Municipal Analysts
- Disclosure Handbook for Municipal Securities
- SEC Releases
- Other Announcements
- Enforcement Actions
- www.sec.gov



QUESTIONS?